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SUBJECT: Part 2 of 2: The U.S. Stake in Developing Mongolia's
Minerals

REF: Ulaanbaatar 0119

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11. (SBU) SUMMARY: In reftel, we described the sharply deteriorating investment climate for mining over the last year. Post recommends raising many of those problems during the forthcoming Trade and Investment Framework Agreement (TIFA) talks, because the U.S. has a major stake in ensuring a favorable business climate for development of and access by U.S. firms to Mongolia's mineral sector. As a friend of Mongolia's economic and political transformation since 1990, we have an interest in ensuring that Mongolia gets right one of the most important issues for its economic development, and handles well the most important public policy challenge the country faces. The mining sector also remains the most important opportunity for U.S. commercial interests, both through potential direct investments by U.S. firms, and through exports of mining-related goods and services. The Embassy and USG have been actively attempting to foster favorable trends, and some international donors are also engaged. END SUMMARY.

Interest 1: Mongolia's Economic Future

12. (SBU) Since Mongolia's peaceful democratic revolution in 1990, a key aim for U.S. policy has been to encourage and assist Mongolia's successful market economic transformation, and to help foster steady economic growth. Development of Mongolia's mineral resources in years to come will be essential to ease poverty (35% of the population is classified as "poor") and bringing development to the nation. Landlocked and sandwiched between China and Russia, Mongolia's only comparative advantage is in producing and selling natural resource commodities to its neighbors. It has very little else to attract substantial foreign investment interest. However, for the minerals sector to prosper, Mongolia will have to find a development model that balances public need with commercial interests and risks. The last year has seen reversals in this

quest.

13. (SBU) With the boundless optimism of a politician, President Enkhbayar recently stated that he believes that minerals development could allow Mongolian per capita incomes to rise to US\$15,000 by 2021, an almost 1,500% increase from their current official GDP levels.

Even the limited mining now occurring has dramatic impacts on the local economy. The tax revenue generated by the state-owned (joint venture with Russia) copper mine at Erdenet alone is the prime support for the new social spending on children and married couples.

Placer gold revenues pump some US\$400 million into the economy (or at least they did before miners started withholding gold to avoid the Windfall Profits Tax enacted last May). In a country of 2.6 million people, some 12,000 workers are directly employed by mining firms. In one early impact of the deteriorating climate for mining investments, Ivanhoe recently discharged some 1,000 workers because they could not obtain an investment agreement on the Oyu Tolgoi deposit from the GOM.

Interest 2: A Key Area for Governance

14. (SBU) Since 1990, the U.S. also has sought to aid Mongolia's democratic transformation. Getting mining development right is among the top two or three most important public policy challenge facing Mongolia. Because it involves state agencies, members of the public and the political classes, and many foreign and domestic businesses, any effective and balanced mining regime is bound to have a salutary effect on the entire governmental, social, and cultural fabric of Mongolia. On the other hand, if it gets things wrong, Mongolia may cripple its economic future by driving away the most responsible foreign investors. It may also squander government

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revenues derived from mining, and witness a further upsurge in corruption fueled by mining wealth. The combined effects of such missteps could endanger political stability and shake the faith of Mongolians in the wisdom of their political choice in 1990 for democracy and a market-oriented economy.

Interest 3: Commercial Opportunities

15. (SBU) Finally, Mongolia's commercial profile for the U.S. is inextricably linked to mining; mining alone holds the prospect of substantial U.S. exports. If a large U.S. or Western mining firm enters Mongolia, a long tail of other U.S. exports are bound to follow, including but not limited to heavy equipment (CAT, Ingersoll-Rand, John Deere, etc.), services firms (like Fluor, which Ivanhoe hired to start developing the Oyu Tolgoi mine, or minerals trading by Gerald's Metals), financial and insurance instruments, and the provision of expertise by U.S. consultants.

16. (SBU) Despite the generally deteriorating investment climate, these desirable commercial outcomes have become more likely over the last year with the advent of two major U.S. players into Mongolia. U.S. coal and energy firm Peabody Energy and copper miner and processor Phelps Dodge (PD) have respectively opened official offices to pursue coal and copper opportunities. Peabody, which has received extensive USG advocacy support, is interested in the Tavan Tolgoi coal project among others, while PD is involved with state-owned Erdenet copper mine on exploration projects. Both firms have expressed the unambiguous desire to "do something" in Mongolia, particularly because of its proximity to China. While expressing some concern about whether projects will be commercially possible in the current Mongolian political environment, they are confident that they can work in Mongolia, if the Mongolians allow their legal and regulatory environment for mining to mature transparently, predictably, and fairly. Both firms have extensive records of using the best practices and working with problematic governments in tough locations; their involvement in Mongolia would help encourage responsible, uncorrupt mining, while prospective Chinese and Russian investors likely would have the opposite effect.

17. (SBU) Although Mongolia's political and economic environment

remains in turmoil, there is every reason to expect that American players would find varying degrees of favor with the Mongolian public, the GOM, and the politicians. Most Mongolian public officials and politicians have expressed an unambiguous desire for American firms to invest into Mongolia. National security concerns (with U.S. investments working to underscore Mongolia's sovereignty and increase bilateral ties, while avoiding economic control of Mongolia's mineral wealth by neighbors China and Russia), the desire for top technology, employment, tax revenues, and need for clean environment, and a belief in the good faith of Americans, are the stated reasons for this preference. In short, the Mongolians see U.S. firms as key that might unlock to the door to their development.

USG Efforts

18. (SBU) Recognizing the crucial role that U.S. firms and the USG might play in development of mining in Mongolia, the Embassy has sought to promote sensible policies on the mining sector and to coordinate support activities with the various players -- donors, businesses, and civil society and environmental NGOs. These efforts have been boosted by the mining industry's newfound (albeit belated) willingness to speak publicly and concretely about the deterioration in the business climate. Our principles are:

-- First, we provide generic support for the mining industry writ large. We regularly and consistently urge the Government of Mongolia at various levels to move forward transparently and in good

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faith to strike deals following international best practices that balance Mongolia's needs with commercial realities and risks. We will also encourage the GOM and a wider Mongolian audience to move prudently but expeditiously, or risk missing current opportunities to benefit from Mongolia's resource endowments.

-- Second, we also stress the importance of good outcomes to the first specific major projects discussed under the revised minerals law -- real talks on real mining projects, most likely the Oyu Tolgoi copper-gold prospect or the Tavan Tolgoi coal deposit -- because these will undoubtedly set the model for negotiations that follow and provide the visible benchmark for all concerned, from mining companies and the Mongolian government to the Mongolian public. While our focus is wider than this specific aim, we also provide particular advocacy efforts on behalf of firms whose projects are identified by our U.S. Department of Commerce as yielding material benefits to U.S. economic interests. To date, DOC has endorsed advocacy for Peabody's efforts to be involved in development of Tavan Tolgoi, and has provided very helpful advocacy letters to senior GOM officials from Commerce Under Secretary Lavin.

Other Foreign Efforts

19. (SBU) The World Bank (WB) and the International Finance Corporation (IFC) have joined with the European Bank of Reconstruction and Development (EBRD) to support Mongolian efforts to develop responsible mining in Mongolia. The WB's Mongolia Country Representative recently explained the nature of the WB/IFC/EBRD efforts to Commoff. The three donors have undertaken to produce a "Scoping Study on Mining in Mongolia," which has been recently released to senior GOM officials. The study is a broad and deep argument that Mongolia needs to adopt a holistic approach to dealing with mining that accounts for the implications of specific projects in their industrial, local, regional, and national implications. The WB Rep noted that IFC and EBRD would look after the commercial aspects of the technical assistance, while the WB funds technical assistance for all other non-commercial areas, including but not limited to labor issues, environment, social impacts, cultural implications, etc.

Goldbeck